

Compensation Issues for Exempt Organizations

Karen Fitch
David Fish

IRS Phone Forum
May 17-18, 2006

IRS Compensation Initiative

- **Goals**
 - Learn how exempt organizations determine and manage compensation
 - Gauge existence and effectiveness of exempt organizations' controls over compensation issues
 - Learn how exempt organizations report compensation on Forms 990 and 990PF
 - Address instances of questionable compensation practices, as well as compensation of specific individuals
 - Increase exempt organizations' awareness of compensation-related tax issues

IRS Compensation Initiative

- Over 1,800 Exempt Organizations Contacted
 - 1225 compliance check letters
 - 600 single issue examinations
- 200 Additional Examinations from Compliance Check Letters

IRS Compensation Initiative

- IRS “Compliance Check”
 - Not an examination
 - Alerts organization about potential error
 - Does not determine tax liability
 - May result in full examination occurring later

IRS Compensation Initiative

- Compliance Check Triggers:
 - Form 990 Schedule A, Part III – No answer or “yes” answer with no explanation
 - Form 990, Part IV, Line 50 – Entry with no explanation
 - Form 990, Part V – Column B blank (non-compensated officers/trustees should show “0” in Column B)

IRS Compensation Initiative

- Compliance Check Triggers (continued):
 - Form 990, Question 89 – No answer or “yes” answer with no explanation

	Yes	No
89a 501(c)(3) organizations. Enter: Amount of tax imposed on the organization during the year under: section 4911 ▶ _____ ; section 4912 ▶ _____ ; section 4955 ▶ _____		
b 501(c)(3) and 501(c)(4) orgs. Did the organization engage in any section 4958 excess benefit transaction during the year or did it become aware of an excess benefit transaction from a prior year? If “Yes,” attach a statement explaining each transaction	89b	
c Enter: Amount of tax imposed on the organization managers or disqualified persons during the year under sections 4912, 4955, and 4958 ▶ _____		
d Enter: Amount of tax on line 89c, above, reimbursed by the organization ▶ _____		

IRS Compensation Initiative

- Examination Issues
 - Organization's compensation policies and procedures
 - Duties and responsibilities of officers, trustees, key employees
 - Compensation oversight by Board/Trustees
 - Reconciliation of Forms 990, 990-PF, W-2, and 1099
 - Individuals' use of organization's assets

IRS Compensation Initiative

- Observations:
 - Compliance check letters effective (“Reach Out and Touch Someone” works)
 - Discovered substantial/undocumented loans loans to insiders (200 new examinations)
 - Organizations spread compensation across related organizations – Question 75 expanded
 - Determining “reasonable” compensation tricky

IRS Compensation Initiative

- Observations (continued):
 - Confusion in reporting deferred compensation
 - Errors in reporting benefits and perks
 - Other general preparer errors
 - IRS forms and instructions should be clear

Executive Compensation Governance

- Key Areas:
 - Legal protection
 - Reporting and disclosure
 - Avoiding automatic excess benefit transactions
 - Transparency

Executive Compensation Governance

- **Conflict of Interest*** – Exists when a governing body considers a compensation arrangement, and a member of the governing body:
 - Is a “Disqualified Person” covered by the arrangement
 - Is subject to the direction/control of a Disqualified Person covered by the arrangement
 - Receives payments approved by a Disqualified Person covered by the arrangement
 - Has a material financial interest affected by the arrangement
 - Receives an economic benefit from the Disqualified Person after approving the arrangement

*Treas. Reg. § 53.4958-6(c)(1)(iii)

Executive Compensation Governance

- *Reasonable Compensation** – amount ordinarily paid for:
 - Like services
 - By like enterprises (whether taxable or tax-exempt)
 - Under like circumstances

*Treas. Reg. § 53.4958-4(b)(1)(ii)(A)

Executive Compensation Governance

- Like Services
 - Type of work?
 - “Hands-on” or general involvement?
 - National or local in scope?
 - Number of employees managed?
 - Budget or assets managed?
 - Managing multiple functions, departments, facilities or entities?

Executive Compensation Governance

- Like Services (continued)
 - Full time or part-time?
 - Two or more related organizations?
 - Whole year, part of a year or final year?
 - Compensation for service in multiple capacities for the same organization or group of related organizations must be aggregated

Executive Compensation Governance

- Like Enterprises
 - Size – by budget, revenues, number of employees, persons served
 - Same business type (pre-school vs. university, nursing home vs. hospital)
 - Can be a mix of non-profit and for-profit entities
 - Entities must be competing for same pool of talent

Executive Compensation Governance

- Like Circumstances
 - Comparables must consist of similar mix of compensation items
 - Include all compensation items, whether taxable or not
 - To avoid automatic excess benefit treatment, report all taxable items
 - Similar geography (urban vs. rural, size of area, cost of living)

Executive Compensation Governance

- How Many Comparables Needed?
 - No specific number required to justify compensation
 - But, meeting rebuttable presumption of reasonableness requires three

Executive Compensation Governance

- Where in the Range of Comparables?

Consider:

- Ratio of revenues to proposed compensation
- Ratio of expenses to proposed compensation
- Executive's track record
- Written offers from unrelated enterprises
- Competitive market pressures
- Special circumstances
- Surveys not a “magic bullet”

Executive Compensation Governance

- Good Compensation Governance
 - Procedures – set and follow
 - Substance – responsible effort to determine appropriate levels
 - Board of Directors/Trustees maintains appropriate oversight

Changes to Form 990 for 2005

75a Enter the total number of officers, directors, and trustees permitted to vote on organization business at board meetings ▶

b Are any officers, directors, trustees, or key employees listed in Form 990, Part V-A, or highest compensated employees listed in Schedule A, Part I, or highest compensated professional and other independent contractors listed in Schedule A, Part II-A or II-B, related to each other through family or business relationships? If "Yes," attach a statement that identifies the individuals and explains the relationship(s) . . .

75b		

c Do any officers, directors, trustees, or key employees listed in Form 990, Part V-A, or highest compensated employees listed in Schedule A, Part I, or highest compensated professional and other independent contractors listed in Schedule A, Part II-A or II-B, receive compensation from any other organizations, whether tax exempt or taxable, that are related to this organization through common supervision or common control?

75c		

Note. Related organizations include section 509(a)(3) supporting organizations.

If "Yes," attach a statement that identifies the individuals, explains the relationship between this organization and the other organization(s), and describes the compensation arrangements, including amounts paid to each individual by each related organization.

d Does the organization have a written conflict of interest policy?

75d		

Part V-B

Former Officers, Directors, Trustees, and Key Employees That Received Compensation or Other Benefits

(If any former officer, director, trustee, or key employee received compensation or other benefits (described below) during the year, list that person below and enter the amount of compensation or other benefits in the appropriate column. See the instructions.)

Changes to Form 990 for 2005

Part II-B Compensation of the Five Highest Paid Independent Contractors for Other Services

(List each contractor who performed services other than professional services, whether individuals or firms. If there are none, enter "None." See page X of the instructions.)

Proposed Regulations – Revocation When IRC §4958 Also Applies

- Apply to Only Section 501(c)(3) Organizations
 - First section – private benefit doctrine still applies; examples illustrate
 - Third section – IRS may deny exemption application for likely future excess benefit transactions; examples illustrate
 - Second section – revocation factors when §4958 also in play

Proposed Regulations – Revocation When IRC §4958 Also Applies

- Revocation Factors
 - Size/scope of exempt function activities before and after excess benefit transaction(s)
 - Size/scope of exempt function activities relative to size/scope of excess benefit transaction(s)
 - Repeated excess benefit transactions
 - Actions taken to prevent recurrence
 - Attempts to seek correction from disqualified person

Proposed Regulations – Revocation When IRC §4958 Also Applies

- Factors to be considered in combination with each other
- Factors not equally weighted
- Last two factors count extra, if before IRS arrives
- Correction by itself not enough

For More Information

- Exempt Organizations Home Page
 - <http://www.irs.gov/charities/index.html>
- Exempt Organizations CPE Texts (Tax Law Training)
 - <http://www.irs.gov/charities/article/0,,id=96441,00.html>
- CPE – Automatic Excess Benefit Transactions
 - <http://www.irs.gov/pub/irs-tege/eotopice04.pdf>